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Defendant, Quality Systems, Inc.

**UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA**

TIMOTHY J. FOSS, Derivatively on
Behalf of Himself and All Others
Similarly Situated,

Plaintiff,

v.

CRAIG A. BARBAROSH, GEORGE H.
BRISTOL, JAMES C. MALONE,
PETER M. NEUPERT, MORRIS
PANNER, D. RUSSELL PFLUEGER,
STEVEN T. PLOCHOCKI, SHELDON
RAZIN, and LANCE E. ROSENZWEIG,

Defendants,

-and-

QUALITY SYSTEMS, INC.,

Nominal Defendant.

Case No. 8:14-cv-00110-CJC-JPR

Derivative Action

**DEFENDANTS' AND NOMINAL
DEFENDANT'S MEMORANDUM
OF POINTS AND AUTHORITIES
IN SUPPORT OF MOTION TO
DISMISS VERIFIED
SHAREHOLDER DERIVATIVE
COMPLAINT**

Judge: Hon. Cormac J. Carney
Date: April 16, 2018
Time: 1:30 p.m.
Place: Courtroom 9B

Oral Argument Requested

TABLE OF CONTENTS

		Page
1		
2		
3	I. INTRODUCTION.....	1
4	II. FACTUAL AND PROCEDURAL BACKGROUND.....	4
5	III. ARGUMENT	6
6	A. Plaintiff Has Not Established That Any Director—Let	
7	Alone A Majority—Is Interested	9
8	1. No Director Faces A Substantial Likelihood Of	
9	Liability Based Upon The Unjust Enrichment And	
10	Insider Trading Claims	9
11	2. No Director Faces A Substantial Likelihood Of	
12	Liability Based Upon The Disclosure Claim.....	11
13	3. No Director Faces A Substantial Likelihood Of	
14	Liability Based Upon The Oversight Claim.....	13
15	a. Plaintiff Admits That QSI Maintained A	
16	System Of Internal Controls.....	14
17	b. Plaintiff Does Not Allege That The Board	
18	Consciously Disregarded Its Duties	15
19	c. Service On Board Committees Does Not	
20	Support An Inference That Any Director	
21	Consciously Disregarded His Duties	17
22	B. Plaintiff Has Not Established That Any Director Lacks	
23	Independence	18
24	1. Plaintiff’s Conclusory Assertion That QSI’s	
25	Directors Are Beholden To Razin Does Not Raise	
26	A Reasonable Doubt As To Their Independence	18
27	2. Razin’s Share Ownership And Plochocki’s	
28	Employment At QSI Do Not Raise A Reasonable	
	Doubt As To Their Independence	20
	C. Plaintiff’s Complaint Should Be Dismissed With	
	Prejudice.....	21
	IV. CONCLUSION	22

TABLE OF AUTHORITIES

Page(s)

CASES

1		
2		
3		
4		
5	<i>Apple, Inc. v. Superior Court,</i>	
6	18 Cal. App. 5th 222 (2017).....	7, 21
7	<i>Aronson v. Lewis,</i>	
8	473 A.2d 805 (Del. 1984).....	7
9	<i>Baca v. Crown,</i>	
10	2010 WL 2812697 (D. Ariz. Jan. 8, 2010).....	8, 10
11	<i>Bader v. Anderson,</i>	
12	179 Cal. App. 4th 775 (2009).....	7, 8, 19
13	<i>Beam v. Stewart,</i>	
14	845 A.2d 1040 (Del. 2004).....	19, 20
15	<i>Clark v. Lacy,</i>	
16	376 F.3d 682 (7th Cir. 2004).....	11
17	<i>Desimone v. Barrows,</i>	
18	924 A.2d 908 (Del. Ch. 2007).....	14
19	<i>Fosbre v. Matthews,</i>	
20	2010 WL 2696615 (D. Nev. July 2, 2010).....	10
21	<i>Guttman v. Huang,</i>	
22	823 A.2d 492 (Del. Ch. 2003).....	8, 11
23	<i>In re Accuray, Inc. S'holder Deriv. Litig.,</i>	
24	757 F. Supp. 2d 919 (N.D. Cal. 2010).....	10
25	<i>In re Am. Apparel, Inc. S'holder Deriv. Litig.,</i>	
26	2012 WL 9506072 (C.D. Cal. July 31, 2012).....	16
27	<i>In re Am. Int'l Grp., Inc. Deriv. Litig.,</i>	
28	700 F. Supp. 2d 419 (S.D.N.Y. 2010), <i>aff'd</i> , 415 F. App'x 285 (2d Cir. 2011).....	11, 16, 18, 21
	<i>In re Baxter Int'l, Inc. S'holders Litig.,</i>	
	654 A.2d 1268 (Del. Ch. 1995).....	8

1	<i>In re Caremark Int’l Inc. Deriv. Litig.</i> ,	
2	698 A.2d 959 (Del. Ch. 1996)	13, 14, 15, 18
3	<i>In re China Auto. Sys. Inc. Deriv. Litig.</i> ,	
4	2013 WL 4672059 (Del. Ch. Aug. 30, 2013).....	10
5	<i>In re Citigroup Inc. S’holder Deriv. Litig.</i> ,	
6	964 A.2d 106 (Del. Ch. 2009)	passim
7	<i>In re CNET Networks, Inc.</i> ,	
8	483 F. Supp. 2d 947 (N.D. Cal. 2007).....	17
9	<i>In re Coinstar Inc. S’holder Deriv. Litig.</i> ,	
10	2011 WL 5553778 (W.D. Wash. Nov. 14, 2011)	13
11	<i>In re Dow Chem. Co. Deriv. Litig.</i> ,	
12	2010 WL 66769 (Del. Ch. Jan. 11, 2010)	9, 15, 18, 20
13	<i>In re Edison Int’l Deriv. Litig.</i> ,	
14	2016 WL 4793186 (S.D. Cal. Sept. 14, 2016)	8
15	<i>In re Extreme Networks, Inc.</i> ,	
16	573 F. Supp. 2d 1228 (N.D. Cal. 2008)	13
17	<i>In re Gen. Motors Co. Deriv. Litig.</i> ,	
18	2015 WL 3958724 (Del. Ch. June 26, 2015)	15
19	<i>In re Goldman Sachs Grp., Inc. S’holder Litig.</i> ,	
20	2011 WL 4826104 (Del. Ch. Oct. 12, 2011).....	8
21	<i>In re Google, Inc. S’holder Deriv. Litig.</i> ,	
22	2013 WL 5402220 (N.D. Cal. Sept. 26, 2013).....	20
23	<i>In re Impax Labs., Inc. S’holder Deriv. Litig.</i> ,	
24	2015 WL 5168777 (N.D. Cal. Sept. 3, 2015).....	8, 16
25	<i>In re Johnson & Johnson Deriv. Litig.</i> ,	
26	865 F. Supp. 2d 545 (D.N.J. 2011).....	16, 17
27	<i>In re Maxwell Techs., Inc., Deriv. Litig.</i> ,	
28	2014 WL 2212155 (S.D. Cal. May 27, 2014)	21
	<i>In re PayPal Holdings, Inc. S’holder Deriv. Litig.</i> ,	
	2018 WL 466527 (N.D. Cal. Jan. 18, 2018)	10, 11, 12

1	<i>In re Polycom, Inc. Deriv. Litig.</i> ,	
2	78 F. Supp. 3d 1006 (N.D. Cal. 2015).....	12, 17
3	<i>In re Silicon Graphics Inc. Sec. Litig.</i> ,	
4	183 F.3d 970 (9th Cir. 1999).....	8
5	<i>In re Yahoo! Inc. S'holder Deriv. Litig.</i> ,	
6	153 F. Supp. 3d 1107 (N.D. Cal. 2015)	passim
7	<i>Kamen v. Kemper Fin. Servs., Inc.</i> ,	
8	500 U.S. 90 (1991)	7
9	<i>Leyte-Vidal v. Semel</i> ,	
10	220 Cal. App. 4th 1001 (2013).....	7
11	<i>Oakland Raiders v. Nat'l Football League</i> ,	
12	93 Cal. App. 4th 572 (2001).....	7
13	<i>Oswald v. Humphreys</i> ,	
14	2016 WL 6582025 (N.D. Cal. Nov. 7, 2016).....	7
15	<i>Potter v. Hughes</i> , 546 F.3d 1051 (9th Cir. 2008).....	7
16	<i>Rales v. Blasband</i> ,	
17	634 A.2d 927 (Del. 1993).....	7
18	<i>Rattner v. Bidzos</i> ,	
19	2003 WL 22284323 (Del. Ch. Sept. 30, 2003)	10
20	<i>South v. Baker</i> ,	
21	62 A.3d 1 (Del. Ch. 2012)	15, 16
22	<i>Stiegele v. Bailey</i> ,	
23	2007 WL 4197496 (D. Mass. Aug. 23, 2007).....	20
24	<i>Stone v. Ritter</i> ,	
25	911 A.2d 362 (Del. 2006).....	14
26	<i>Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera</i> ,	
27	119 A.3d 44 (Del. Ch. 2015).....	19, 21
28	<i>Wood v. Baum</i> ,	
	953 A.2d 136 (Del. 2008).....	13, 16, 17

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
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23
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25
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27
28

STATUTES

42 U.S.C. § 1395w-4(o)(1)	4
Cal. Corp. Code § 1601	6

RULES

Fed. R. Civ. P. 23.1	6, 7
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REGULATIONS

75 Fed. Reg. 44,314	5
77 Fed. Reg. 13,698	5

1 Nominal defendant QSI and Defendants (as defined in the Notice of Motion
2 and Motion) move to dismiss Plaintiff's Complaint with prejudice.

3 **I. INTRODUCTION**

4 After QSI's share price fell 33% on July 26, 2012, several shareholder
5 lawsuits followed. Former director and second-largest shareholder Ahmed
6 Hussein was the first to file on October 4, 2013, alleging that QSI, its former
7 Chairman Sheldon Razin, and its former CEO and director Steven Plochocki lied
8 to him about the Company's growth prospects and breached their fiduciary duties
9 (the "Hussein Action"). The California Superior Court granted summary judgment
10 in favor of defendants and dismissed the Hussein Action in 2015. In November
11 2013, a group of investors filed a federal securities class action in this Court (the
12 "Securities Class Action"), similarly alleging that QSI, Razin, Plochocki, and
13 former CFO Paul Holt publicly misrepresented the Company's growth
14 opportunities. This Court dismissed the Securities Class Action, but the Ninth
15 Circuit partially reversed.

16 Sensing an opportunity, Plaintiff filed this action on January 24, 2014—two
17 months after the Securities Class Action—purportedly on behalf of QSI.
18 Plaintiff's Complaint closely tracks the other two; in fact, it attaches the complaint
19 from the now-dismissed Hussein Action as an exhibit. Plaintiff contends that
20 QSI's Board breached their fiduciary duties by (i) causing or allowing QSI to issue
21 the alleged misstatements (the "disclosure claim"), and (ii) failing to oversee the
22 Company or maintain a system of internal controls (the "oversight claim").
23 Plaintiff also claims that Razin was unjustly enriched, and that Plochocki engaged
24 in insider trading.

25 Plaintiff's Complaint should be dismissed with prejudice because he has not
26 complied with the shareholder demand requirement set forth in Federal Rule of
27 Civil Procedure 23.1. This requirement reflects the fundamental principle of
28 corporate governance that a company's important business decisions should be

1 made by its board of directors, not individual shareholders. One of those important
2 decisions is whether to pursue litigation on the corporation's behalf. For this
3 reason, shareholders like Plaintiff may pursue derivative claims only in rare
4 circumstances: where the shareholder has made a demand to initiate litigation that
5 the board has wrongfully refused, or where demand is excused because a majority
6 of the board is incapable of considering it impartially.

7 Plaintiff did not make a demand before filing this lawsuit. Consequently, he
8 must allege particularized facts demonstrating that a majority of QSI's Board at the
9 time he filed his Complaint—Barbarosh, Bristol, Malone, Neupert, Panner,
10 Pflueger, Plochocki, Razin, and Rosenzweig—either was interested or lacked
11 independence, and therefore was incapable of making an informed decision as to
12 whether the filing of a lawsuit was in the Company's best interest. Plaintiff does
13 not adequately allege either prong.

14 To establish interestedness, Plaintiff must demonstrate, on a director-by-
15 director basis, that a majority of the Board faces a substantial likelihood of liability
16 with respect to at least one of his claims. Conclusory allegations will not suffice;
17 Plaintiff must allege particularized facts—*i.e.*, dates, specific actions, and
18 knowledge—showing that the directors acted intentionally or in bad faith. He has
19 not done so.

20 The unjust enrichment and insider trading claims address only one director
21 each (Razin for unjust enrichment, Plochocki for insider trading). A majority of
22 the Board, therefore, cannot face a substantial likelihood on those claims. Nor do
23 the conclusory allegations in the Complaint expose Razin or Plochocki to a
24 substantial likelihood of liability on the claims. Plaintiff does not allege any
25 specific facts explaining how Razin profited improperly at the expense of the
26 Company. Similarly, Plaintiff does not identify any particularized facts
27 demonstrating that Plochocki sold stock on the basis of material, non-public
28 information.

1 Likewise, no director faces a substantial likelihood of liability on the
2 disclosure or oversight claim. Three Board members (Malone, Neupert, and
3 Panner) joined after the alleged misconduct occurred, and thus cannot be liable as a
4 matter of law. As to the remaining six directors (five of whom need to be found
5 interested in order to excuse demand), Plaintiff's allegations fall well short.

6 With respect to the disclosure claim, Plaintiff must plead particularized facts
7 showing—again, on a director-by-director basis—that the alleged false statements
8 were made knowingly or in bad faith. Plaintiff does not plead any facts
9 establishing that the Board was even involved in drafting the alleged
10 misstatements, much less that any of the directors knew that the statements were
11 false or misleading.

12 With respect to the oversight claim, Plaintiff must allege particularized facts
13 demonstrating that the directors (a) utterly failed to implement any reporting
14 system or controls, or (b) having implemented those controls, consciously failed to
15 monitor or oversee them. Plaintiff concedes that the Company had reporting
16 systems and controls in place—thereby negating any claim that it “utterly failed”
17 to adopt them. Likewise, Plaintiff does not allege that any director consciously
18 ignored alleged deficiencies in the Company's control system. At most, Plaintiff
19 points to two letters from the Securities and Exchange Commission (“SEC”)
20 in 2012, which asked about the assumptions regarding QSI's forecasts. But
21 Plaintiff acknowledges that the Company addressed the letters within days, and the
22 SEC took no further action.

23 Because Plaintiff has failed to establish that any director faces a substantial
24 likelihood of liability on his claims, the question of director independence need not
25 be examined: independence is only relevant to the demand-futility analysis when
26 there exists an interested person. Even if Plaintiff had shown that any director was
27 interested, the Complaint contains no particularized facts demonstrating that any
28 other director—let alone a majority of the other directors—was so beholden to that

1 interested person that he could not impartially consider whether to bring the
2 asserted claims. Plaintiff baldly claims that Board members are beholden to Razin.
3 But he does not support that assertion with facts, particularized or otherwise. On
4 the contrary, Plaintiff does not allege that any director even has a relationship with
5 Razin, let alone one that is so bias-inducing that it would rebut the presumption of
6 independence afforded to every director. Because Razin does not face a substantial
7 likelihood of liability, he is not interested, and there is no need to conduct an
8 independence analysis; but even if Plaintiff had established Razin's interestedness,
9 Plaintiff has failed to meet his burden of demonstrating that a majority of the
10 Board at the time the Complaint was filed was beholden to Razin.

11 Plaintiff has not met his burden to establish demand futility, and his
12 Complaint should be dismissed with prejudice. If he were permitted to amend, the
13 demand requirement would be reassessed against the current Board—the majority
14 of whose members joined after the alleged misconduct took place and therefore
15 cannot be liable on Plaintiff's claims. Demand would not be futile, but amendment
16 would be.

17 **II. FACTUAL AND PROCEDURAL BACKGROUND¹**

18 QSI is a publicly-traded California corporation that develops and markets
19 electronic health records solutions for medical and dental providers. Compl.
20 ¶¶ 2, 13. In 2009, Congress passed the American Recovery and Reinvestment Act
21 of 2009 ("ARRA"), which, among other things, provided incentives to promote the
22 adoption of electronic healthcare record ("EHR") technology. 42 U.S.C. § 1395w-
23 4(o)(1)(A), (E). In 2010, the U.S. Department of Health and Human Services
24 ("HHS") adopted rules pursuant to which medical providers that adopted certified
25 EHR technology would be entitled to receive incentive payments between 2011
26

27 ¹ This background is based upon the allegations and documents referenced in the
28 Complaint and documents that the Court may consider because they are
incorporated by reference or are subject to judicial notice. The exhibits cited are
attached to the Declaration of Andrew R. Gray, which is filed with this Motion.

1 and 2013. 75 Fed. Reg. 44,314, 44,321-23 (July 28, 2010).

2 As a provider of certified EHR technology, QSI believed that ARRA would
3 spur growth. *See* Ex. 3. Accordingly, when QSI released its fiscal year 2011
4 results on May 26, 2011, QSI also announced that for fiscal year 2012 (“FY2012”),
5 it agreed with analysts’ projections that the Company’s revenue and earnings
6 would increase year-over-year.² Compl. ¶ 43. For the first three quarters of
7 FY2012, QSI experienced record growth. *See id.* ¶ 44. As its results surpassed
8 expectations, QSI increased its FY2012 guidance. *See id.* During the last month
9 of QSI’s FY2012, HHS proposed delaying the roll-out of certain previously
10 adopted rules to allow “vendors to develop Certified EHR Technology.” 77 Fed.
11 Reg. 13,698, 13,701 (Mar. 7, 2012).

12 On May 10, 2012, QSI announced its preliminary FY2012 results: while the
13 Company achieved its revenue guidance, QSI missed its earnings guidance. *See*
14 Ex. 4. QSI explained that delays in closing certain deals had caused its earnings
15 miss. *Id.* QSI remained confident in its prospects, however, and announced that
16 for FY2013, the Company expected revenues and earnings to increase 20% to
17 24%, and 20% to 25%, respectively. *Id.*; Compl. ¶ 52. QSI reiterated the guidance
18 in connection with a proxy contest brought by Ahmed Hussein. Compl. ¶¶ 55, 59,
19 61.

20 QSI announced its first quarter FY2013 results on July 26, 2012. *Id.* ¶ 63.
21 While QSI’s quarterly revenue increased 18% from the prior year, its earnings
22 (though positive) decreased year-over-year. *Id.*; Ex. 6. Because of “lower than
23 expected revenue from large, higher margin software system sales” and the
24 “evolving conditions affecting [QSI’s] industry,” QSI announced that it would not
25 affirm its prior guidance. Compl. ¶ 63; Ex. 6. QSI’s share price fell 33% that day.
26 Compl. ¶ 4.

27 ² QSI’s FY2012 began on April 1, 2011 and ended March 31, 2012. Its fiscal year
28 2013 (“FY2013”) began on April 1, 2012 and ended on March 31, 2013. *See*
Compl. ¶ 47.

1 In October 2013, Hussein filed a lawsuit against QSI, its then-CEO
2 Plochocki, and its Board Chairman Razin in California state court, alleging fraud
3 and breach of fiduciary duty in connection with the July 26, 2012 disclosure and
4 stock price decline—which, according to Hussein, forced the sale of millions of his
5 QSI shares, which he had pledged as collateral for loans. Compl. Ex. A. The court
6 granted summary judgment to defendants in September 2015. On November 19,
7 2013, the Deerfield Beach Police Pension Fund filed the Securities Class Action in
8 this Court against the Company, Plochocki, Razin, and then-CFO Paul Holt.
9 Compl. ¶ 4. The Securities Class Action similarly alleged that QSI made material
10 misstatements regarding its growth prospects and that the truth about these
11 purported misstatements became known on July 26, 2012. *See id.*³

12 In January 2014, Plaintiff filed this action, alleging breaches of fiduciary
13 duty, abuse of control, mismanagement, unjust enrichment, and insider trading
14 against certain members of QSI’s Board. Plaintiff’s allegations are premised upon
15 those set forth in the Hussein and Securities Class Actions. Before filing, Plaintiff
16 did not make a books-and-records inspection request. *See* Cal. Corp. Code § 1601.
17 Nor did he make a pre-suit demand on QSI’s nine-member Board—which included
18 three members who joined the Board after the alleged misconduct occurred
19 (Neupert, Malone, and Panner). Compl. ¶¶ 79-80.

20 **III. ARGUMENT**

21 Under Rule 23.1, a putative derivative plaintiff either must make a pre-suit
22 demand on a company’s board of directors to enforce a company right, or “state
23 with particularity” the reasons why making such demand would be futile. *See* Fed.

24 ³ On October 20, 2014, this Court dismissed the Securities Class Action with
25 prejudice. *See In re Quality Systems, Inc. Sec. Litig.*, No. 8:13-cv-01818-CJC-JPR,
26 Dkt. No. 39 (C.D. Cal. Oct. 20, 2014). After the plaintiffs appealed, the Ninth
27 Circuit affirmed the decision with respect to the free-standing forward-looking
28 statements, but permitted so-called “mixed” statements containing both forward-
looking and non-forward-looking components to proceed to discovery. On January
26, 2018, defendants in the Securities Class Action filed a petition for a writ of
certiorari with the United States Supreme Court, requesting that the Court
reevaluate the Ninth Circuit’s order. Ex. 9.

1 R. Civ. P. 23.1. “[S]trict compliance with Rule 23.1 . . . is necessary before a
2 derivative suit can wrest control of an issue from the board of directors.” *Potter v.*
3 *Hughes*, 546 F.3d 1051, 1058 (9th Cir. 2008).

4 Where, as here, Plaintiff did not make a pre-suit demand on the Company’s
5 Board, the Complaint must be dismissed unless he alleges particularized facts
6 showing that demand would have been futile under the law of the Company’s state
7 of incorporation, *i.e.*, California. *See Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S.
8 90, 108-09 (1991); *see also* Compl. ¶ 13.⁴ California courts employ two tests in
9 assessing demand futility: (1) the *Aronson* test, which applies when the claim
10 challenges a specific board decision or action; and (2) the *Rales* test, which applies
11 in all other circumstances. *See Bader v. Anderson*, 179 Cal. App. 4th 775, 791
12 (2009) (citing *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) and *Rales v. Blasband*,
13 634 A.2d 927 (Del. 1993)); *see also Apple, Inc. v. Superior Court*, 18 Cal. App. 5th
14 222 (2017) (same). The inquiry under both tests is essentially identical. *See Leyte-*
15 *Vidal v. Semel*, 220 Cal. App. 4th 1001, 1010-11 (2013). Under either test,
16 demand is excused where particularized factual allegations “create a reasonable
17 doubt that, as of the time the complaint is filed, the board of directors could have
18 properly exercised its independent and disinterested business judgment in
19 responding to a demand.” *Bader*, 179 Cal. App. 4th at 791-92; *see also Oswald v.*
20 *Humphreys*, 2016 WL 6582025, at *1 (N.D. Cal. Nov. 7, 2016).

21 Specifically, Plaintiff must establish that a majority of the Board at the time
22 the Complaint is filed (1) is “interested”—*i.e.*, that a director’s actions were “so
23 egregious . . . that . . . a substantial likelihood of . . . liability” exists with respect to
24 one of the alleged claims (*Aronson*, 473 A.2d at 815); or (2) lacks
25 “independence”—*i.e.*, “is ‘beholden’ to an interested director or officer, ‘or so
26 under their influence that their discretion would be sterilized.’” *Bader*, 179 Cal.

27 ⁴ In matters of corporate governance, California law is identical to Delaware law
28 “for all practical purposes.” *See Oakland Raiders v. Nat’l Football League*, 93
Cal. App. 4th 572, 586 n.5 (2001).

1 App. 4th at 792 (citation omitted); *see also In re Silicon Graphics Inc. Sec. Litig.*,
2 183 F.3d 970, 990 (9th Cir. 1999) (a “mere threat” of liability is insufficient to
3 establish demand futility). To meet this standard, Plaintiff must satisfy a heavy
4 burden that is “more onerous than that required to withstand a Rule 12(b)(6)
5 motion.” *Baca v. Crown*, 2010 WL 2812697, at *5 (D. Ariz. Jan. 8, 2010).
6 Plaintiff also must overcome the presumption that directors are “faithful to their
7 fiduciary duties.” *In re Impax Labs., Inc. S’holder Deriv. Litig.*, 2015 WL
8 5168777, at *4 (N.D. Cal. Sept. 3, 2015) (citation omitted).

9 In assessing whether a director is interested, the likelihood of liability is
10 “significantly lessened” where the Company’s certificate of incorporation
11 exculpates directors from liability to the extent authorized by applicable law. *In re*
12 *Goldman Sachs Grp., Inc. S’holder Litig.*, 2011 WL 4826104, at *18 (Del. Ch.
13 Oct. 12, 2011); *see also In re Edison Int’l Deriv. Litig.*, 2016 WL 4793186, at *4
14 (S.D. Cal. Sept. 14, 2016) (in assessing demand futility, court must “take[] into
15 consideration the exculpatory provisions in [company’s] certificate of
16 incorporation”). Because QSI has adopted such a provision (Exs. 1-2), a
17 substantial threat of liability necessary to render a member of the Board interested
18 “may only be found to exist if the plaintiff pleads a *non-exculpated* claim against
19 the directors based on particularized facts.” *Guttman v. Huang*, 823 A.2d 492, 501
20 (Del. Ch. 2003). This means “plaintiffs must plead particularized facts showing
21 bad faith” to establish a substantial likelihood of liability. *Goldman*, 2011 WL
22 4826104, at *18 (citation omitted).

23 Plaintiff does not allege particularized facts sufficient to establish that any
24 Board member—let alone a majority—engaged in such “egregious” (*i.e.*, bad faith)
25 conduct that they face a substantial likelihood of liability on Plaintiff’s claims. *In*
26 *re Baxter Int’l, Inc. S’holders Litig.*, 654 A.2d 1268, 1271 (Del. Ch. 1995). As a
27 result, the independence of the directors need not be examined, since that analysis
28

1 is only relevant when there exists an interested person. *See In re Dow Chem. Co.*
2 *Deriv. Litig.*, 2010 WL 66769, at *8 & n.38 (Del. Ch. Jan. 11, 2010).

3 Even assuming Plaintiff established that a director faced a substantial
4 likelihood of liability on one of the claims, however, Plaintiff does not plead any
5 particularized facts that any Board member (much less a majority) is “beholden” to
6 that person and therefore lacks independence. His Complaint should be dismissed
7 with prejudice. *See, e.g., In re Yahoo! Inc. S’holder Deriv. Litig.*, 153 F. Supp. 3d
8 1107, 1128 (N.D. Cal. 2015) (dismissing complaint with prejudice for failure to
9 establish demand futility).

10 **A. Plaintiff Has Not Established That Any Director—Let Alone A**
11 **Majority—Is Interested**

12 Plaintiff asserts seven causes of action: (1) unjust enrichment against Razin;
13 (2) insider trading against Plochocki; (3) breach of fiduciary duty against all
14 Defendants for disseminating allegedly false statements; (4) breach of fiduciary
15 duty against all Defendants for failure to maintain internal controls; (5) breach of
16 fiduciary duty against all Defendants for failure to oversee the Company; (6) abuse
17 of control against all Defendants; and (7) gross mismanagement against all
18 Defendants. To excuse demand based upon interestedness, Plaintiff must
19 demonstrate that five of QSI’s nine directors face a substantial likelihood of
20 liability on his claims. He does not do so.

21 **1. No Director Faces A Substantial Likelihood Of Liability**
22 **Based Upon The Unjust Enrichment And Insider Trading**
23 **Claims**

24 Demand is not excused with respect to the unjust enrichment and insider
25 trading claims because they do not address a majority of the Board. The unjust
26 enrichment claim pertains only to Razin, and the insider trading claim pertains only
27 to Plochocki. *See Compl.* ¶¶ 104-109. Where claims are brought against a
28 minority of directors, “a majority of the Board survives scrutiny under the demand
futility analysis.” *In re China Auto. Sys. Inc. Deriv. Litig.*, 2013 WL 4672059, at
*10 (Del. Ch. Aug. 30, 2013); accord *In re PayPal Holdings, Inc. S’holder Deriv.*

1 *Litig.*, 2018 WL 466527, at *6 (N.D. Cal. Jan. 18, 2018) (where insider trading
2 claim is brought against only one director, plaintiff could not establish demand was
3 futile because there were not “particularized facts indicating that a majority of the
4 Board would lack disinterestedness or independence in making a decision on a
5 demand as to that claim”); *Baca*, 2010 WL 2812697, at *10 (where claim was
6 asserted against less than half of the board, plaintiff did not satisfy demand futility
7 requirements); *Fosbre v. Matthews*, 2010 WL 2696615, at *7 (D. Nev. July 2,
8 2010) (same).

9 Even as to Razin and Plochocki, Plaintiff’s allegations fall far short of
10 establishing a substantial likelihood of liability. Plaintiff fails to show how Razin
11 was unjustly enriched “at the expense of” QSI. *In re Accuray, Inc. S’holder Deriv.*
12 *Litig.*, 757 F. Supp. 2d 919, 935-36 (N.D. Cal. 2010). Plaintiff has not pled any
13 facts—let alone particularized ones—describing what improper “profits, benefits,
14 and other compensation” Razin allegedly received. *See* Compl. ¶ 106. Razin
15 therefore does not face a substantial likelihood of liability on the unjust enrichment
16 claim.

17 Likewise, Plaintiff’s claim that Plochocki sold QSI stock “at inflated prices”
18 cannot establish interestedness under settled law, which requires particularized
19 allegations demonstrating “that the challenged sales were executed upon the basis
20 and because of non-public information.” *See Rattner v. Bidzos*, 2003 WL
21 22284323, at *12 (Del. Ch. Sept. 30, 2003). Plaintiff states that Plochocki sold
22 QSI stock while possessing “undisclosed information” at some point over a three-
23 year period. Compl. ¶ 5. Plaintiff does not make any allegations regarding the
24 timing of Plochocki’s sales or his previous sales patterns—facts necessary to
25 determine whether the challenged sales were suspicious. Nor does Plaintiff plead
26 any specific facts supporting an inference that Plochocki made the trades “upon the
27 basis and because of” material non-public information. *Rattner*, 2003 WL
28 22284323, at *12. Plaintiff’s conclusory allegations lack the particularity required

1 to render Plochocki interested on this claim. *See Guttman*, 823 A.2d at 502
2 (declining to find that a director is interested based on cursory allegations “that he
3 made sales of company stock in the market at a time when he possessed material,
4 non-public information”); *PayPal*, 2018 WL 466527, at *6 (dismissing claim
5 where “plaintiffs rely upon conclusory statements about ‘suspicious’ sales based
6 on knowledge derived from being a member of [the company’s] board”).

7 **2. No Director Faces A Substantial Likelihood Of Liability**
8 **Based Upon The Disclosure Claim**

9 Plaintiff contends that QSI’s Board of directors breached their fiduciary
10 duties, or otherwise abused their positions of control, by “causing or allowing the
11 Company to disseminate materially misleading and inaccurate information.” *See*
12 *Compl.* ¶¶ 83, 96 (regarding Counts I, IV).⁵ In order to show a substantial
13 likelihood of liability based upon a disclosure claim, Plaintiff must plead
14 particularized facts identifying “which disclosures were misleading, when the
15 Company was obligated to make disclosures, what specifically the Company was
16 obligated to disclose, . . . how the Company failed to do so,” and how the directors
17 “made disclosures with knowledge that they were false or misleading or in bad
18 faith.” *In re Citigroup Inc. S’holder Deriv. Litig.*, 964 A.2d 106, 132-33 & n.88
(Del. Ch. 2009). Plaintiff has not shown any of this.

19 Three of the directors (Malone, Neupert, and Panner) joined the Board in
20 2013—well after QSI made the alleged misstatements. *Compl.* ¶¶ 16-18. They
21 cannot face any liability with respect to this claim. *See In re Am. Int’l Grp., Inc.*
22 *Deriv. Litig.*, 700 F. Supp. 2d 419, 440 (S.D.N.Y. 2010) (where directors “joined
23 the Board after [the alleged misstatements were made] none of them faces any
24 potential for liability”), *aff’d*, 415 F. App’x 285 (2d Cir. 2011).

25 Plaintiff’s allegations regarding the remaining six directors (Barbarosh,
26

27 ⁵ Because Plaintiff’s abuse-of-control claim simply repackages his breach of
28 fiduciary duty claim under a different name, it is appropriate to consider the two
claims together. *See, e.g., Clark v. Lacy*, 376 F.3d 682, 687 (7th Cir. 2004).

1 Bristol, Rosenzweig, Pflueger, Razin, Plochocki) likewise are deficient. Plaintiff
2 states repeatedly that these directors “caus[ed] or allow[ed] the Company to
3 disseminate materially misleading and inaccurate information.” Compl. ¶¶ 83, 96.
4 Under settled law, however, alleging that directors “‘caused or allowed’ the
5 Company to issue certain statements is not sufficient particularized pleading to
6 excuse demand[.]” *Citigroup*, 964 A.2d at 133 n.88. Plaintiff must—but has
7 failed to—make particularized allegations regarding “how the board was actually
8 involved in creating or approving the statements,” or specific allegations that any
9 of the directors “made disclosures with knowledge that they were false or
10 misleading or in bad faith.” *Id.* In fact, Plaintiff has not “made any specific
11 allegations about the [directors’] state of mind at all.” *See In re Polycom, Inc.*
12 *Deriv. Litig.*, 78 F. Supp. 3d 1006, 1016 (N.D. Cal. 2015). Absent “particularized
13 allegations explaining what the Directors knew, when they knew it, or anything
14 more than ‘general allegation[s] that the Board participated’ in making or causing
15 false or misleading statements to be made,” there can be no inference “that the
16 board acted in bad faith, knowingly, or with intent to deceive.” *Id.* at 1017
17 (citations omitted). In other words, because Plaintiff does not provide a basis to
18 infer that Defendants “knew about [the Company’s] alleged wrongdoings at the
19 time the challenged statements were issued, [he] cannot show that a majority of the
20 Board faced a substantial likelihood of liability.” *See PayPal*, 2018 WL 466527,
21 at *6.

22 Plaintiff also claims—incorrectly—that Razin, Barbarosh, Bristol,
23 Rosenzweig, Pflueger, and Plochocki face a substantial likelihood of liability
24 because they served on a “Special Committee that was responsible for the
25 Company’s Proxy Materials and all signed the June 26, 2012 letter containing
26 [allegedly] misleading guidance.” Compl. ¶ 80(b)-(c). As an initial matter, QSI’s
27
28

1 SEC filings (upon which Plaintiff's claims are based (Compl. at 1⁶)) make clear
2 that Barbarosh, Rosenzweig, and Plochocki did *not* serve on the Committee. *See*
3 Ex. 5. In any event, it is well-settled that directors do not have "a culpable state of
4 mind" based on committee service alone. *See Wood v. Baum*, 953 A.2d 136, 142-
5 43 (Del. 2008). Plaintiff does not allege any particularized facts suggesting that
6 the Special Committee "had an actual role in the alleged misstatements or that the
7 Committee knew of inaccuracies in the challenged statements." *In re Coinstar Inc.*
8 *S'holder Deriv. Litig.*, 2011 WL 5553778, at *4 (W.D. Wash. Nov. 14, 2011).
9 Likewise, that certain directors "'signed' or were involved in 'reviewing' the
10 disclosures at issue" does not excuse demand, as those allegations are insufficient
11 to create an inference that the directors had actual or constructive notice of any
12 illegality. *See Yahoo!*, 153 F. Supp. 3d at 1120; *see also In re Extreme Networks,*
13 *Inc.*, 573 F. Supp. 2d 1228, 1241 (N.D. Cal. 2008) ("[A] director's execution of
14 financial reports, without more, is insufficient to create an inference that he had
15 actual or constructive notice of any illegality.").

16 **3. No Director Faces A Substantial Likelihood Of Liability** 17 **Based Upon The Oversight Claim**

18 Plaintiff next alleges that the Defendants failed to maintain internal controls
19 or exercise proper oversight. Compl. ¶¶ 85-94, 100-103 (regarding Counts II, III,
20 V).⁷ These allegations—though styled as separate counts—constitute what is
21 commonly referred to as a *Caremark* claim. *See Yahoo!*, 153 F. Supp. 3d at 1121
22 (analyzing claims that board disregarded their duty to oversee the company and

23 ⁶ It is appropriate for the Court to consider QSI's public filings and other
24 documents incorporated by reference to Plaintiff's Complaint in ruling on the
25 Motion to dismiss for the reasons set forth in Defendants' accompanying Request
That the Court Consider Documents Incorporated by Reference or Subject to
Judicial Notice.

26 ⁷ Plaintiff's "gross mismanagement" claim is not an independent cause of action,
27 but rather is properly treated as a breach of fiduciary duty claim. *See Citigroup*,
28 964 A.2d at n. 6 ("These common law [breach of fiduciary duty] standards govern
the duties that directors and officers owe the corporation as well as claims such as
those for 'reckless and gross mismanagement,' even if those claims are asserted
separate and apart from claims of breach of fiduciary duty.") (citations omitted).

1 failed to maintain internal controls as a *Caremark* claim); *see also In re Caremark*
2 *Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

3 To excuse demand based upon a *Caremark* claim, Plaintiff must plead
4 particularized facts showing that ““(a) the directors utterly failed to implement any
5 reporting or information system or controls; or (b) having implemented such a
6 system or controls, consciously failed to monitor or oversee its operations, thus
7 disabling themselves from being informed of risks or problems requiring their
8 attention.”” *Yahoo!*, 153 F. Supp. 3d at 1121 n.7 (quoting *Stone v. Ritter*, 911 A.2d
9 362, 370 (Del. 2006)). Under both *Caremark* prongs, “imposition of liability
10 requires a showing that the directors knew that they were not discharging their
11 fiduciary obligations.” *Stone*, 911 A.2d at 370. Only a “sustained or systematic
12 failure of the board to exercise oversight . . . will establish the lack of good faith
13 that is a necessary condition to liability.” *Caremark*, 698 A.2d at 971. As a result,
14 in order to state a viable *Caremark* claim, and to predicate a substantial likelihood
15 of director liability on it, a plaintiff must plead the existence of facts suggesting
16 that the directors’ “indolence was so persistent that it could not be ascribed to
17 anything other than a knowing decision not to even try to make sure the
18 corporation’s officers had developed and were implementing a prudent approach to
19 ensuring law compliance.” *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch.
20 2007). For this reason, a *Caremark* claim has been described as “possibly the most
21 difficult theory in corporation law upon which a plaintiff might hope to win a
22 judgment.” *Citigroup*, 964 A.2d at 125 (citation omitted). Plaintiff comes
23 nowhere close to meeting the rigorous *Caremark* standard.

24 **a. Plaintiff Admits That QSI Maintained A System Of**
25 **Internal Controls**

26 Plaintiff’s own allegations refute any assertion that the Board “utterly failed”
27 to implement internal controls. He concedes that the Company established a Code
28 of Business Conduct that (i) required its employees to “respect and obey the laws
of the cities, states and countries in which [it] operate[s]” (Compl. ¶ 30), and (ii)

1 prohibited employees from trading in QSI stock on the basis of material, non-
2 public information (*id.* ¶ 32). Plaintiff also acknowledges that the Company had an
3 Audit Committee that was responsible for, among other things, determining
4 whether there were “any significant deficiencies in the design or operation of
5 internal controls or material weaknesses therein and any fraud involving
6 management or other employees who have a significant role in the Company’s
7 internal controls.” *Id.* ¶ 33.

8 These admissions “do not support an inference of an ‘utter failure to attempt
9 to assure a reasonable information and reporting system exists,’ but rather the
10 opposite: an evident effort to establish a reasonable system.” *South v. Baker*, 62
11 A.3d 1, 18 (Del. Ch. 2012) (quoting *Caremark*, 698 A.2d at 971); *see also*
12 *Polycom*, 78 F. Supp. 3d at 1015 (by acknowledging the “existence of [the
13 company’s] Audit Committee,” plaintiff admitted that “internal controls were in
14 place throughout the relevant period”); *Dow Chem.*, 2010 WL 66769, at *13 n.85
15 (“Plaintiffs cannot simultaneously argue that the [company’s] board ‘utterly failed’
16 to meet its oversight duties yet had ‘corporate governance procedures’ in place”).
17 Plaintiff’s allegations—that the level of oversight may have been inadequate in
18 hindsight—falls well short of pleading that there was an utter failure to implement
19 controls. *See In re Gen. Motors Co. Deriv. Litig.*, 2015 WL 3958724, at *15 (Del.
20 Ch. June 26, 2015) (allegations that there was “*some* oversight, albeit not to the
21 Plaintiffs’ hindsight-driven satisfaction” did not satisfy *Caremark* burden).

22 **b. Plaintiff Does Not Allege That The Board Consciously**
23 **Disregarded Its Duties**

24 Nor does Plaintiff allege that the Board consciously failed to monitor the
25 Company’s operations. Demand is excused under this *Caremark* prong where
26 Plaintiff pleads “with particularity that there were so-called ‘red flags’ that put the
27 directors on notice of problems with their systems, but which were consciously
28 disregarded.” *Yahoo!*, 153 F. Supp. 3d at 1121 (citation omitted).

1 Plaintiff has not pled any facts showing the existence of red flags that put the
2 Board on notice of “serious misconduct” or “evidence of illegality.” *Baker*, 62
3 A.3d at 15. At most, Plaintiff identifies two SEC comment letters from 2012
4 asking QSI to describe the assumptions underlying the FY2013 projections in its
5 proxy materials. *See* Compl. ¶¶ 57, 59. But red flags “are only useful when they
6 are either waved in one’s face or displayed so that they are visible to the careful
7 observer.” *Wood*, 953 A.2d at 143 (citation omitted). Plaintiff does not allege that
8 the directors received the letters, much less explain how the letters could have
9 alerted the Board to systemic deficiencies in the Company’s internal controls. *See*
10 *In re Am. Apparel, Inc. S’holder Deriv. Litig.*, 2012 WL 9506072, at *26 (C.D.
11 Cal. July 31, 2012) (demand was not futile where the board was not alerted that
12 there was “a high likelihood” that the company was violating the law but failed to
13 rectify the behavior). On the contrary, the letters did not claim that QSI violated
14 any laws and did not “shed light on whether the [Company] actually engaged in
15 misconduct.” *In re Johnson & Johnson Deriv. Litig.*, 865 F. Supp. 2d 545, 566
16 (D.N.J. 2011). They do not constitute red flags. *See Impax*, 2015 WL 5168777, at
17 *3, *5 (FDA Form 483s were not “red flags” because they “simply informed . . . of
18 ‘conditions that *may* constitute violations of the law’”); *Baker*, 62 A.3d at 15
19 (describing “red flags” as “evidence of illegality” or “notice of serious
20 misconduct”).

21 Furthermore, even if the SEC comment letters constituted red flags (they do
22 not), none of the Board members faces a substantial likelihood of liability for
23 consciously disregarding them. First, three of the directors (Malone, Neupert, and
24 Panner) joined the Board after QSI received and responded to the letters (Compl.
25 ¶¶ 17-19), and thus face no liability with respect to this claim. *See Yahoo!*, 153 F.
26 Supp. 3d at 1128 n.14 (directors do not face a substantial likelihood of liability
27 where they “joined the board after the events at issue in this litigation”); *Am. Int’l*
28 *Grp.*, 700 F. Supp. 2d at 440 (where directors “all joined the Board after the

1 [alleged wrongdoing] had been concluded,” they do not face a substantial
2 likelihood of liability). Plaintiff’s conclusory assertion that these directors
3 “ratified” the alleged misconduct (Compl. ¶ 28) does not expose them to liability
4 because the Complaint provides no details about the supposed ratification. *See In*
5 *re CNET Networks, Inc.*, 483 F. Supp. 2d 947, 963-64 (N.D. Cal. 2007)
6 (conclusory allegations that directors “ratified” misconduct are insufficiently
7 particularized).

8 Second, QSI did not disregard the letters. As Plaintiff acknowledges, QSI
9 “filed a revised preliminary proxy statement attempting to address the SEC’s”
10 comments. *See* Compl. ¶ 59. In other words, Plaintiff’s own allegations
11 acknowledge that the Company “was responding appropriately” to the SEC’s
12 comment letters—not ignoring them. *See Johnson & Johnson*, 865 F. Supp. 2d at
13 566. Indeed, after receiving QSI’s responses, the SEC took no further action.

14 **c. Service On Board Committees Does Not Support An**
15 **Inference That Any Director Consciously Disregarded**
His Duties

16 Finally, Plaintiff’s allegation that Bristol and Pflueger are “interested” or
17 “conflicted” due to their service on QSI’s Audit Committee (Compl. ¶ 80(e)) is
18 contrary to well-established law, which does not permit an inference of culpability
19 based solely on committee membership. *Wood*, 953 A.2d at 142 (“Plaintiff also
20 asserts that membership on the Audit Committee is a sufficient basis to infer the
21 requisite scienter. That assertion is contrary to well-settled Delaware law.”);
22 *accord Polycom*, 78 F. Supp. 3d at 1020. Plaintiff does not allege with
23 particularity any of the facts necessary to establish liability based upon committee
24 service—including when the committee convened, what each director learned
25 regarding the alleged misconduct by serving on the committee, and how each
26 director consciously and in bad faith failed to discharge his fiduciary obligations in
27 light of such knowledge. *See Yahoo!*, 153 F. Supp. 3d at 1122; *Polycom*, 78 F.
28 Supp. 3d at 1020; *Citigroup*, 964 A.2d at 134. Plaintiff has not pled any facts

demonstrating that any Board member systematically and in bad faith failed to exercise oversight under the stringent *Caremark* standard.

B. Plaintiff Has Not Established That Any Director Lacks Independence

Because Plaintiff has failed to establish that any director is interested (*i.e.*, faces a substantial likelihood of liability with respect to at least one of the claims), the independence of the Board members “need not be examined,” as that issue “is only relevant [to the demand-futility analysis] when there exists an interested person.” *Dow Chem.*, 2010 WL 66769, at *8 & n.38; *see also Bader*, 179 Cal. App. 4th at 792 (director lacks independence only where the “director is ‘beholden’ to an interested director or officer, ‘or so under [the interested director’s or officer’s] influence that their discretion would be sterilized’”) (citation omitted). In any event, even if Plaintiff adequately had alleged that any director was interested, he fails to establish that any other director lacks independence, *i.e.*, that he is beholden to, or controlled by, an interested person. *See Am. Int’l Grp.*, 700 F. Supp. 2d at 435 (allegations that directors are beholden to another “does not further Plaintiff’s demand futility claim” where person is not found to be interested).

1. Plaintiff’s Conclusory Assertion That QSI’s Directors Are Beholden To Razin Does Not Raise A Reasonable Doubt As To Their Independence

Plaintiff contends that the directors were beholden to one person: Razin. *See* Compl. ¶¶ 7, 80. This means that the independence inquiry rests entirely on Plaintiff’s allegations surrounding individual directors’ relationships with, and alleged domination by, Razin. The Complaint says nothing about Razin’s relationship with any director—and instead contains sweeping statements about Razin’s alleged control over all of them. Plaintiff’s assertion that the Board is “entangled in a web of corporate interests built around Defendant Razin” is long on rhetoric, but devoid of particularized facts necessary to rebut the presumption of independence afforded every director. *Id.* ¶ 80(a); *see also Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera*, 119 A.3d 44, 59 (Del. Ch. 2015).

1 In order to show a lack of independence, Plaintiff's Complaint must create a
2 "reasonable doubt" that a director is so beholden to an interested director (which
3 Plaintiff claims is Razin) that his or her "discretion would be sterilized." *Beam v.*
4 *Stewart*, 845 A.2d 1040, 1050 (Del. 2004). The relationship "must be of a bias-
5 producing nature"—allegations of a mere personal friendship or business
6 relationship are insufficient to raise a reasonable doubt about an individual
7 director's independence. *Id.*

8 In *Beam*, for example, the plaintiff could not establish that directors of
9 Martha Stewart Living Omnimedia were beholden to Stewart, who owned 94% of
10 the company's shares. 845 A.2d at 1051. According to the Delaware Supreme
11 Court, allegations that Stewart and other directors "moved in the same social
12 circles, attended the same weddings, developed business relationships before
13 joining the board, and described each other as 'friends,' even when coupled with
14 Stewart's 94% voting power," were insufficient to rebut the presumption of
15 independence. *Id.*

16 Plaintiff's allegations are far less detailed than those dismissed in *Beam*.
17 Plaintiff does not allege that a single Board member has a relationship with Razin,
18 much less one that is "so substantial that [the director] would be more willing to
19 risk his or his reputation than risk the relationship." *Bader*, 179 Cal. App. 4th at
20 834 (citing *Beam*, 845 A.2d at 1052). Instead, Plaintiff lifts allegations from the
21 complaint in the Hussein Action—which was dismissed over two years ago—and
22 baldly claims that in 2004, Razin "orchestrated the appointment of a new slate of
23 directors beholden to him." Compl. ¶ 69 (citing complaint in Hussein Action).
24 Plaintiff never identifies who these directors were, the factual basis for his claim
25 that they were "beholden" to Razin at the time of their appointment—or indeed,
26 that they remained "beholden" throughout the ensuing decade—or whether they
27 remained on the Board at the time Plaintiff filed his Complaint. Most importantly,
28 Plaintiff does not plead any facts supporting an inference that Razin's relationship

1 with any director serving on the Board at the time of Plaintiffs' Complaint was "so
2 close that [their] independence may *reasonably* be doubted." *Beam*, 845 A.2d
3 at 1051.

4 **2. Razin's Share Ownership And Plochocki's Employment At**
5 **QSI Do Not Raise A Reasonable Doubt As To Their**
6 **Independence**

7 Plaintiff incorrectly contends that Razin lacks independence because he
8 holds approximately 17% of the Company's stock. Compl. ¶¶ 21, 80(b). As
9 explained above, independence in the demand-futility context relates only to
10 whether a director is beholden to another person who faces a substantial likelihood
11 of liability. *See In re Google, Inc. S'holder Deriv. Litig.*, 2013 WL 5402220, at *7
12 (N.D. Cal. Sept. 26, 2013) ("[T]he only relevant question [in assessing
13 independence] is whether Page and Brin are independent from Schmidt, as
14 Schmidt is the only director who can be considered 'interested.'"). The fact that
15 Razin owns a significant number of shares says nothing about whether he is
16 beholden to an interested person. Rather, the only reasonable inference that can be
17 drawn is that he is an "economically rational individual whose priority is to protect
18 the value of his . . . shares." *Stiegele v. Bailey*, 2007 WL 4197496, at *15 (D.
19 Mass. Aug. 23, 2007) (citation omitted).

20 Likewise, Plaintiff alleges that Plochocki lacks independence because
21 Plochocki received "substantial monetary compensation" from QSI as its CEO.
22 Compl. ¶ 80(d). This, again, suggests that Plochocki is beholden to the
23 Company—not to an interested person. *See Dow Chem.*, 2010 WL 66769, at *8
24 ("[P]laintiffs allege that the three inside directors . . . depend for their livelihood on
25 [the company] . . . [W]here a director is beholden to the *company* there is no reason
26 to doubt her loyalty to that company."). Indeed, Plochocki's position "merely
27 indicates that his interests were aligned with the corporation's interests, and is not
28 a ground for challenging his disinterestedness." *See Am. Int'l Grp.*, 700 F. Supp.
2d at 434; *Dow Chem.*, 2010 WL 66769, at *8 (management's "interests are

1 aligned with the company and presumably she is able to make decisions in the best
2 interests of the company”) (citation omitted). That Plochocki was not considered
3 independent under NASDAQ rules “does not bear upon independence for demand
4 futility purposes. The two standards are completely different.” *In re Maxwell*
5 *Techs., Inc., Deriv. Litig.*, 2014 WL 2212155, at *6 (S.D. Cal. May 27, 2014); *see*
6 *also Baiera*, 119 A.3d at 61 (“a board’s determination of director independence
7 under the NYSE Rules is qualitatively different from, and thus does not operate as
8 a surrogate for, this Court’s analysis of independence” for demand futility
9 purposes).

10 **C. Plaintiff’s Complaint Should Be Dismissed With Prejudice**

11 Plaintiff’s Complaint should be dismissed with prejudice because he cannot
12 establish that demand on QSI’s current Board is futile. If granted leave to amend,
13 Plaintiff must “plead demand futility against [the Company’s] current board of
14 directors,” not the Board sitting at the time he filed the Complaint in 2014. *See*
15 *Yahoo!*, 153 F. Supp. 3d at 1128 n.14.

16 A majority of QSI’s current Board joined after the events described in the
17 Complaint, and cannot face any liability on Plaintiff’s claims. *See id.* (“[D]emand
18 plainly could not be excused given that, with [one] exception . . . all of [the]
19 current directors joined the board after the events at issue in this litigation.”); *see*
20 *also* Exs. 7-8 (five of QSI’s nine directors joined the Board after the events at
21 issue). Plaintiff therefore cannot identify “facts that indicate amendment could
22 cure the defects in the Complaint.” *Yahoo!*, 153 F. Supp. 3d at 1128 n.14; *see also*
23 *Apple*, 18 Cal. App. 5th 222, at *9 (“[W]hen a trial court declares derivative claims
24 to be legally insufficient and grants leave to amend, the demand requirement must
25 be reassessed against the disinterest and independence of the board of directors in
26 place when the amended derivative claims are filed.”). Dismissal with prejudice is
27 appropriate.

IV. CONCLUSION

For the reasons stated, the Complaint should be dismissed with prejudice.

Dated: February 2, 2018

LATHAM & WATKINS LLP

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